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Economic Growth Officers Training Workshop

Module 5: Privatization

Privatization and Corporate Governance: Building Blocks of Enterprise Development

- Privatization seeks to:
  - Create accountable management
  - Change fundamentally the way business decisions are made
- Privatization provides access to capital, know-how, markets
- Ownership change by itself is not enough
  - Privatization without effective *corporate governance* structures does not bring accountability, improve management decision-making, develop more competitive enterprises
- Privatization and corporate governance ***together*** become a powerful tool for creating economic growth
  - Improving management
  - Providing access to capital

Agenda

- Ownership
  - Privatization objectives, programs and experiences
  - The Case of PPK, part 1
  - Infrastructure
- Governance
  - PPK, part 2
  - Ownership, governance and management structures
- The role of USAID
  - Key elements for program and project designers

Key Messages

- Ownership transfer matters
  - It establishes the foundations for improved decision-making at the enterprise level
  - It allows government to focus scarce managerial and financial resources, and relieves budgetary burden on the government
  - It can lead to improved economic efficiency and growth
- We know how to do privatization well
- Only the "easy" privatization is "done"
  - Difficult infrastructure and social services remain

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Privatization Objectives, Programs, and Experiences

The Case of CAF, Part 1

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The Privatization of PPK, Part 1

- PPK pre-privatization
  - Leading manufacturer of petrochemicals in Trondheim (oil-rich country of 15 million)
  - Employed +10,000 people
  - Strategic relationship with large US-based petrochemicals giant
  - Monthly sales declining
  - Operating margin had become negative
  - Debt load climbing
  - Company insolvent, though some products were generating profits

PPK, Part 1 (Cont'd)

- The operating environment
  - World-wide the industry seeing slow growth
    - Result of soft economy, weather
- Trondheim economy prior to PPK privatization
  - GDP had plunged to –20% 18 months ago, prior to privatization it was predicted to be at at 2% this year
  - Inflation had raged and currency had collapsed
    - In recent months inflation had dropped to 35%, financial markets collapsed and most SOEs were insolvent
  - Number of people in poverty had doubled in last 2 years
  - External debt had grown
  - Newly elected democratic leader for the first time, following decades of military rule
  - Sector liberalization was allowing new entrants

PPK, part 1 (Cont'd)

- Privatization program was being started
- Choices being considered
  - IPO
  - Private placement to strategic investor
- Role of restructuring?

- *WHAT WOULD YOU RECOMMEND?*
  - *Would your recommendation change if this was a different sector? Why?*

Why Privatize PPK?

Trondheim government had many goals:

- Broad social or macroeconomic goals:
  - Positive impact on economic growth
  - Increase competitiveness
  - Increase employment
  - Reform public sector
  - Retire public debt/improve public finances
  - Broaden share ownership
- Enterprise specific and microeconomic goals:
  - Increase efficiency
  - Attract investment
  - Improve competitiveness
  - Attract new Technology/Know-how

CAN ONE PROGRAM ACHIEVE ALL THIS?

PPK, Part 1: Outcome

- Privatized through IPO
  - Percentage of the shares (about 1/3) reserved for small investors sold out first day
  - Foreign investors took about ¼ of the shares
  - A State-Owned distribution company ended up with the largest block of shares, or 15% of the equity
  - Raised more than expected for the Finance Ministry
  - To make company attractive, GoT forgave the huge company debt
- Year after its privatization:
  - Debt continued to rise
  - Operating margin negative and company had to be bailed out again

How is privatization carried out?

- Three broad types of programs
  - Transactional approach
    - Case by case approach emphasizes investment banking skills, investor outreach capabilities
  - Pipeline management approach
    - Focus on process of making decisions about SOEs, and for taking them through tender
  - Sector de-monopolization and regulatory restructuring

Key Message:

Most "pure" privatization programs have focused on just parts of the process

Successful Privatization Programs Spanning the Policy-Transaction Continuum

Issues:

Policy - Legal and Regulatory Frameworks

- ✓Privatization Law
- ✓Financial Sector
- ✓Social & Labor Issues
- ✓Competition Policy
- ✓Corp.Gov. and Shareholder Rights

Institutional Development

- ✓Privatization agencies
- ✓Sectoral ministries
- ✓Regulatory agencies
- ✓Banking & Capital Markets Institutions
- ✓Corporate Governance structures

Transactions - Sector & Enterprise Specific

- ✓Sectoral Analysis/ Restructuring
- ✓Enterprise preparation/ passive restructuring
- ✓Sales strategy & process
- ✓Negotiations

Post-privatization - Sector & Enterprise Specific

- ✓Active restructuring:
  - product lines
  - financial systems
  - organizational
  - labor
  - social assets
- ✓Domestic/International investment
- ✓Corporate Governance

Key Elements of Effective Privatization Programs

1. Address legal and institutional environment up front
2. Have clear decision-making processes
3. Anticipate and plan for challenges
4. Ensure flexibility to choose appropriate privatization methods
5. Consider the impact of enterprise/sector restructuring

1. Legal and Institutional Reform is a Central Part of Privatization

- Commercial laws and judicial system
- Corporate governance and shareholder rights enforcement
- Tax reform and accounting standards
- Bankruptcy laws
- Labor laws
- Banking/capital markets laws and regulations
- Foreign direct investment laws and regulations

While not all of these need to be sorted out up front, the fundamentals in most of these areas must be in place

2. Clear Decision-Making Processes are Key
(create clear objectives)

- Who ultimately decides what companies get put on the block?
- Who decides whether whether to take the offer on the table from the investor?
- What are the processes in place to select advisors, to evaluate bids, select and negotiate with the bidder?
  - Who “owns” the SOE shares? What governance arrangements are in place and how do these affect decision-making on privatization matters?
- Who are the stakeholders and what powers do each have in the process?
  - Who is motivated to privatize and how?
  - Do the stakeholders that have an incentive to privatize also own the decision-making process?

3. Anticipate and Plan for Challenges

- Valuation gap (and political risks associated with perceived low prices)
- Impact on labor (labor retrenchment, displacement, and retraining, social safety nets)
- Foreign vs. national investors
- Preferences for strategic or financial investors
- Management of the process (cooperating with SOEs and other line Ministries, making decisions, etc.)
- Transparency of the privatization process
- Expectations in terms of duration and pipeline management

Problems in these areas can kill or severely delay a program.

How much flexibility does the government have on these issues?

4. Choose Appropriate Privatization Methods

- Auction sale
- Public sale of equity shares (IPO)
- Non-sale distribution (voucher program)
- Liquidation (sale of assets)
- Buy-out by management or employees
- Concessions, leases and management contract

What Method is Appropriate?

- Choice of privatization method depends on
  - need for outside capital, technology, know-how
  - desired outcome in terms of control of the firm following privatization
  - market situation
  - pressure on government budgets
  - timing/costs
  - public perception
- Each choice must balance a number of different and sometimes conflicting priorities
- Combining methods may be the best approach

5. The Role of Restructuring: The Broader Institutional Environment

- Sector restructuring
  - *Vertically* integrated sectors may be "unbundled" so that specific segments can be privatized using various methods
    - e.g., Agriculture: production, processing, marketing/exporting
    - e.g., Power: generation, transmission, distribution
  - *Horizontally* integrated sectors may be "unbundled" to create a pool of potential competitors in a given segment of the market
    - Allows comparative competition between comparable entities in different regions
    - e.g., Power: horizontal unbundling involves breaking up generation into separate companies

Challenges in Strategic Sectors

- Key industrial sectors (i.e. crown jewels)
  - “Perceived” as strategic
  - Highly politicized, particularly vs. foreign involvement
  - Many require sectoral unbundling and possibly some regulations
  - Transaction should incorporate some citizen participation
- Agriculture
  - Land ownership and rural employment issues
- Social Sectors
  - Pension/social security, health, education
- Infrastructure
  - Characterized by high sunk costs, elements of “natural” monopoly
  - Likely to be reliant on government subsidies
  - Likely to be subject to price controls and public service obligations (PSOs)
  - “Commercialization” is often necessary prior to privatization

Public-Private Partnerships (PPPs)

- A tool for creating the conditions for private sector entry (with private sector know-how, financing and other resources) into “difficult” sectors
  - Education, health, water
- Will not solve all sector problems, but enables government to focus its resources where they are most needed
- USAID is pioneering PPPs in social sectors like education and health care
  - Workforce in IT project by USAID/Egypt is creating new model for PPPs to introduce IT in schools and e-leaning as a tool for teacher training

Spectrum Of PPP Techniques

Public → **Private**

New Investments

Build Transfer	Build Transfer Operate	Build Lease Transfer	Build Operate Transfer	Build Operate Own

Privatization

Service Contracts	Management Contracts	Lease	Concession	Partial/Full Divestiture

Regulatory Issues In PPPs

- Setting fair tariffs/prices
- Determining, setting and monitoring performance measures
- Installing independent regulator and separating operations from supervision and monitoring
- Competition policy
- Enforcement

PPPs: Examples in Education

- E-Education
  - The TSP model in Egypt's IT in School Program
  - The SHOMA program in Africa

Governance

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Corporate Governance: The Case of PPK, one year later

- Questions to consider
  - What are the restructuring challenges?
  - How does PPK's Corporate Governance structure help or hinder its ability to meet these challenges?
  - How does Corporate Governance support capital markets development?

Corporate Governance: What is it?

- Set of principles and structures that determines rights and obligations of stakeholders in the firm
- CG seeks to balance the interests and expectations of stakeholders and promote efficient business decision-making
- Principles of effective corporate governance are:
  - Transparency
  - Disclosure
  - Accountability
  - Legality
  - Loyalty

Two Models of Corporate Governance

- German Model
  - Close relations between industry and financial institutions
    - Reflects emphasis traditional emphasis on debt vs. equity financing, smaller stock markets
    - Individual shareholders invest through banks, transferring voting rights to the bank via proxy
  - Less stringent disclosure requirements
  - Two tier board
  - Employees have statutory role in the board

Two Models of Corporate Governance

- US Model
  - Diverse ownership
    - Strong, anti-monopoly regulations
    - Large and liquid markets
    - Strong legal backing of shareholder rights
  - Separation of financial institutions and industry (conflict of interest rules)
  - Strict disclosure requirements
  - One board
    - De facto control of the proxy process by management
  - Employees have no statutory role

Corporate Governance Structures

- Corporate Governance structures emerge from national development patterns, customs, laws and regulations, culture, financial organizations, markets
- All corporate governance structures share some basic characteristics:
  - General Meeting of Shareholders (or similar structures that provide shareholders a voice in company decision-making)
  - A management structure responsible to the General Meeting of Shareholders
  - Shareholders’ right to sue or seek redress
- Globalization of trade and capital are leading to convergence of CG practices
  - Increased disclosure, transparency, protection of minority shareholder rights

Corporate Governance: Key Messages

- Creating wide ownership does not by itself create market discipline
- CG structures are critical for efficient decision-making, and to maintain competitiveness at the firm level
- CG is critical to attract outside capital, know-how and expertise
  - CG structures are particularly important when markets are shallow and illiquid
- No model out there fits all circumstances
  - Applicability depends on structure of the capital markets, liquidity and ease of exit, structure of shareholdings, human resources available, government regulations

Models for Successful Approaches to CG

- There are few models of successful implementation
  - Donors, and USAID, are still struggling to define effective approaches
  - But experience has shown that effective CG programs focus less on the legal aspects and more on creating effective advocacy for change in decision-making structures
  - CG programs can include: legal reform and rule of law, capital market development, accounting reform, human capacity development/training (including training of the accounting profession) and grass roots advocacy
  - Competitiveness work (National Competitiveness Councils)

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